No. 10,932.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

PAUL W. SAMPSELL, Trustee in Bankruptcy of the Estate of El Camino Refining Company, STATE OF CALIFORNIA and UNIVERSAL CONSOLIDATED OIL COMPANY,

Appellees.

Upon Appeal from the District Court of the United States for the Southern District of California.

BRIEF FOR THE UNITED STATES.

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BRIEF FOR THE UNITED STATES.

Opinion Below.

The District Court entered no opinion.

Jurisdiction.

This case involves a contest between lien claimants, including the United States for gasoline taxes for various months of the years 1941 and 1942, over the assets of the bankrupt, the El Camino Refining Company. The original petition for reorganization of the debtor under Chapter X of the Bankruptcy Act of 1898, as amended by the Chandler Act of 1938, was filed on May 12, 1942. [R.

2-7.] The claim of the United States was filed on July 3, 1942. [R. 52-53.] The order of the referee was filed on March 2, 1944. [R. 76-77.] The petition for review of the referee's order was filed on April 10, 1944. [R. 78-80.] The order of the District Court, affirming the order of the referee, was entered on September 7, 1944. [R. 86-87], and the notice of appeal was filed on October 6, 1944 [R. 99]. The jurisdiction of this Court rests upon Section 128(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

1. Whether the District Court erred in holding that under Section 67 of the Bankruptcy Act the liens of the United States for gasoline taxes were not entitled to priority in payment over the inchoate general liens of the State of California for franchise taxes.

2. Whether the District Court erred in allowing interest to the Universal Consolidated Oil Company on the principal sum due under its mortgage, subsequent to the date of adjudication in bankruptcy, or sale, with the mortgagee's consent, of the mortgaged property free and clear of all liens.

3. Whether the District Court erred in subordinating the tax liens of the United States to the payment of attorney's fees and interest on the principal sum due under the mortgage to the Universal Consolidated Oil Company subsequent to the date of adjudication in bankruptcy.

Statutes Involved.

The applicable statutes involved are set forth in the Appendix, *infra,* pp. 31 to 35.

Statement.

The District Court adopted as its own the findings of fact and conclusions of law contained in the referee's order of March 2, 1944. [R. 87.] As relevant to this appeal they may be summarized as follows:

On May 12, 1942, the El Camino Refining Company filed its petition for reorganization under Chapter X of the National Bankruptcy Act of 1898, as amended by the Chandler Act of 1938. The court thereupon, and on the 12th day of May, 1942, made an order to the effect that this petition was properly filed and was filed in good faith, and continuing the debtor corporation in possession of its assets. Thereafter, and on the 8th day of March, 1943, an order was made adjudicating the corporation a bankrupt, and referring further proceedings in the administration of its estate to Ben E. Tarver, a referee in bankruptcy. Thereafter, and on the 27th day of March, 1943, Paul W. Sampsell, with the approval of the referee, was appointed trustee in bankruptcy of the estate, and thereafter and on the 31st day of March, 1943, duly qualified. Ever since the 31st day of March, 1943, Paul W. Sampsell has been, and now is, the duly appointed, qualified and acting trustee in bankruptcy of the estate. [R. 61.]

The assets of the bankrupt estate consisted of real and personal property. By the consent of all lien claimants, all of this property, real and personal, has been sold for $19,927.85 under the direction and control of the Court. The sale has been consummated and the purchase price paid to the trustee. By the consent of all lien claimants, and with the approval of the trustee and the Court, all liens claimed upon the property have been transferred to the fund realized from the sales, subject to such ex-

penses of administration fixed by the Court, after due notice, which arise out of the costs and expenses of the preservation of the property, its liquidation and reduction to cash, the determination of the status and relativity of liens asserted upon this cash, and the proper distribution of such cash among the persons entitled to share in it. [R. 62-63.]

On April 3, 1943, the State of California, by and through the California State Franchise Tax Commissioner, filed a claim for franchise taxes in the sum of $3,701.35, plus interest. This claim was based upon the following items: (1) taxes accruing as of January 1, 1939, for the calendar year 1939, in the sum of $1,406.12; and (2) taxes accruing as of January 1, 1940, for the calendar year 1940, in the sum of $1,446.24. The exact amount of these taxes was not fixed and determined at the time they accrued but were fixed and determined prior to the commencement of the bankruptcy proceedings.[1]

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[1]Although the findings of fact apparently were not amended, the referee, pursuant to direction of the Court, amended his certificate of review by deleting the above sentence and substituting in lieu thereof the following [R. 81-82]:

> The bankrupt corporation filed its California Franchise Tax return for the taxable years 1939 and 1940, reporting its computation of income received during the income years of 1938 and 1939 and paid the taxes shown to be due for the taxable years 1939 and 1940 by said return. Thereafter and on January 3, 1941 the California Franchise Tax Commissioner under the provisions of Section 25 of the Act (Act 8488 of Deering's General Laws for 1937) determined that additional income had been received and additional amounts of taxes were due and gave due notice to the bankrupt that the returns filed by the bankrupt had been examined and the correct amount of taxes determined by the Commissioner and that he proposed to assess additional taxes in specified amounts, giving the details of the proposed additional assessments and the method of computing the same. Thereupon the bankrupt filed a protest with

[R. 65.] After the commencement of the bankruptcy proceedings, and during their course, after consideration of a protest made by the bankrupt corporation, the amounts of such taxes, so fixed and determined prior to bankruptcy, were voluntarily reduced by the State of California to the sums of $1,406.12, as of January 1, 1939, and $1,446.24, as of January 1, 1940. The above taxes bear interest at the rate of 6% per annum from the date of their accrual until paid. The amount due thereon, principal and interest, as of January 15, 1944, is the sum of $3,634.22, plus interest thereon thereafter at the rate of 6% per annum until paid. [R. 65.]

On May 10, 1943, after proceedings had and taken for that purpose, and after due notice to all parties in interest, the referee made an order allowing to Universal Consolidated Oil Company, a corporation, a secured claim upon the real property, by reason of a real property mortgage thereon, in the principal sum of $8,444.08, with interest thereon thereafter, at the rate of 5% per annum from March 15, 1943, until paid. This mortgage was executed and delivered on January 10, 1941, by the bankrupt corporation to the Universal Consolidated Oil Company, and thereafter recorded on May 3, 1943,[2] in Book

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the California Franchise Tax Commissioner. On March 12, 1942, the time of the commencement of the above-entitled proceeding under Chapter X of the Bankruptcy Act, said protest was pending for determination before the California Franchise Tax Commissioner. Thereafter and on August 13, 1942, the California Franchise Tax Commissioner redetermined the tax liability and reduced the amount of the additional taxes proposed in the said notices of January 3, 1941.

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[2]This appears to be an error. the correct date of record being May 3, 1941. [R. 29.]

1089, at page 508, in the official records of Orange County, California. The mortgage secures the payment of a promissory note executed and delivered by the bankrupt to the Universal Consolidated Oil Company on January 10, 1941. [R. 66.]

The note provides: "Should it become necessary to bring action for the collection of this note, the maker hereby agrees to pay a reasonable attorney's fee to be fixed by the Court." [Rec. 66.] The mortgage provides that it secures the payment to the mortgagee of [R. 66-67.]

> attorney's fees in a reasonable sum to be fixed by the court in any action brought to foreclose this mortgage, or in any action or proceeding affecting or purporting to affect the security of this mortgage or the right of mortgagee hereunder, in which mortgagee may appear, whether brought by mortgagor or mortgagee, or whether such foreclosure action, or other action, or proceedings progress to judgment.

The balance due, as of January 15, 1944, upon the note and mortgage, principal and interest, exclusive of attorney's fees, is the sum of $10,484.78, plus interest thereon thereafter at the rate of 5% per annum until paid. The mortgage was contested before the referee on the hearings, by the United States of America, which contended that this mortgage insofar as it covered the machinery, fixtures and equipment upon the oil refinery plant, purported to be a chattel mortgage covering personal property, and that such machinery, fixtures and equipment were personal property instead of real property. The mortgagee employed the law firm of Faries & McDowell of Los Angeles to represent the mortgagee in connec-

tion with the foreclosure of the mortgage in the bankruptcy proceedings, and to defend its validity as a real property mortgage, the lien of which was entitled to be satisfied out of the proceeds of such sale of the oil refinery, subject only to any prior valid liens thereon established by the court, and the expenses of administration fixed and allowed by the court. The above counsel rendered valuable services in connection with such matters. These services are of the reasonable value of $750. Due notice of the time and place of the hearing of the application of the firm of Faries & McDowell for the allowance of $750 for their services in this connection, was given to the creditors of the bankrupt estate by mail, pursuant to the provisions of Section 58 of the Bankruptcy Act. Upon the hearing of this application, no objection was made thereto. [R. 67.]

The bankrupt has, at all times since the close of the following months, been indebted to the United States of America for gasoline taxes in the amounts set forth below, together with interest thereon as provided by law. [R. 69.] The assessment lists of the Commissioner of Internal Revenue, carrying these taxes, were received by the Collector of Internal Revenue, at Los Angeles, California on the following dates [R. 70]:

Month	Amount of Tax	Assessment List Received
October, 1941	$ 301.16	January 6, 1942
November, 1941	6,301.31	January 23, 1942
December, 1941	3,751.83	March 24, 1942
January, 1942	6,090.77	April 28, 1942
February, 1942	6,335.70	May 8, 1942

A claim for these federal gasoline taxes was filed on June 20, 1942. [R. 70.]

On December 23, 1943, the referee signed filed and entered an order allowing and ordering paid out of the estate forthwith the total sum of $6,929.83 as expenses of administration of the type and character hereinbefore referred to. There will not be sufficient funds in the estate wherewith to pay such expenses of administration, and the valid liens of the State of California, and of the Universal Consolidated Oil Company. There will be sufficient money in the estate to pay such expenses of administration so allowed, and the tax liens of the State of California hereinbefore referred to, and a substantial sum in connection with the mortgage lien of the Universal Consolidated Oil Company hereinbefore referred to. There will be other expenses of administration of the same type and character which will, necessarily, be allowed and paid before the closing of this case. There will not be left any funds on hand wherewith to pay any valid liens of the United States of America for taxes, or any debts entitled to priority of payment pursuant to Section 64-a of the Bankruptcy Act other than expenses of administration, or any claims of general creditors against the bankrupt estate. [R. 74.]

The referee then concluded and ordered that [R. 76-77]:

> (1) The State of California holds a valid first lien upon the funds now in the hands of the Trustee

in Bankruptcy in the sum of $3,634.22, as of January 15, 1944, plus interest thereon thereafter at the rate of 6% per annum until paid.

(2) The Universal Consolidated Oil Co., a corporation, holds a valid second lien upon such funds in the sum of $11,234.78, as of January 15, 1944, plus interest thereon thereafter at the rate of 6% per annum until paid.

(3) Both the said first and the said second lien are subject to the payment of the expenses of administration fixed by the court herein, after hearing upon due notice to the parties herein, which arise out of the costs and expenses of the property affected by such liens, its liquidation and reduction into cash, the determination of the status and relativity of the liens asserted upon such cash, and the proper distribution of said cash among the persons entitled to the same. If the assets of the estate are insufficient to pay such liens and such expenses, then such expenses shall first be paid, next the said first lien of the State of California, and then the balance remaining to the Universal Consolidated Oil Co. in connection with its said second lien.

(4) No further consideration need be given to the validity or amount of any tax liens asserted upon the funds of the estate by the United States of America, unless it ultimately appears that there will be sufficient funds in the estate to pay all such expenses of administration and said first and second liens of the State of California and the Universal Consolidated Oil Co. in full.

From the order of the District Court affirming this order the United States Government prosecutes this appeal.

Statement of Points to Be Urged.

The appellant's statement of points to be urged, all of which are here relied upon, appear in the record at pages 100 to 103. They may be summarized by the statement that the District Court erred in holding that the United States was not entitled to priority in payment for gasoline taxes out of the bankrupt estate over the claims of the State of California for franchise taxes, and of the Universal Consolidated Oil Company for interest and attorney's fees relating to its mortgage.

Summary of Argument.

The issue on this phase of the appeal deals with the relative priorities of the State of California and the United States as *lien* claimants of a bankrupt. The Government's liens for gasoline taxes attached at the times the Collector received the assessment lists which, in a sufficient number of instances were prior to the filing of the petition on May 12, 1942. They were specific, perfected liens which did not have to be recorded to be valid against a state and which could not be displaced by later liens imposed by authority of any state law or judicial decision. On the other hand at the times the Government's liens attached, California had at most inchoate general liens for franchise taxes. They were uncertain as to amount and property subject thereto. Although this did not deprive them of being valid liens under Section 67(b) of the Bankruptcy Act, it did deprive them of being specific and perfect. And it is submitted that under Section 67 of the Bankruptcy Act, in a contest between a prior inchoate lien holder and the Government as a tax lien claimant, the Government takes priority whether or not the inchoate lien is subsequently perfected.

Morever *United States v. Texas*, 314 U. S. 480, conclusively answers the contention that since the mortgage was conceded to prime the Government's tax liens and the state liens were entitled to be satisfied under California law before the mortgage, the state liens were entled to first priority. Despite the circuity, the United States tax liens are still entitled to be satisfied before the tax liens of California. Since the mortgage is ahead of the Government's liens, the Government urges that the procedure inferentially approved in *Spokane County v. United States*, 279 U. S. 80, and which will satisfy the relative priorities of California and the mortgagee be here adopted, and that the amounts finally allowable to the mortgagee be paid first and the tax liens of the United States thereafter, with a provision that the State of California satisfy its tax claims out of the amounts allowable to the mortgagee.

The Government recognizes that the general rule that interest stops running upon both secured and unsecured claims after a debtor has passed into bankruptcy unless the estate turns out to be solvent, is limited by the exception in favor of the secured creditor whose security is sufficient to pay his claim for interest as well as principal. However, the exception applies only where the contest is between the secured and general creditors and not between two lien holders on the same property, as is the case here. Just as priority claims not secured by liens are not granted interest unless the principal of all claims may be paid in full, so where property is subject to two liens interest will not run on the superior to the detriment of the principal of the second. Thus the court was in error to allow interest to the mortgagee from the date

of the petition to the detriment of the principal sum to the United States as the second lienor.

But there is a more fundamental reason why, aside from any question of insolvency, the mortgagee is not entitled to subordinate the United States tax liens to a greater sum than existed on the date the Government's liens attached. Although Congress may have subordinated its tax lien to a prior existing mortgage, the lien cannot be displaced without its consent by increasing the amount of the prior incumbrance by the accrual of interest or the addition of attorney's fees for services to be rendered in the future pursuant to state law or a judicial decision. And neither the interest nor the attorney's fee can be said to be an incident of and relate back to the original debt for the doctrine of relations will not divest the United States of its priorities.

Moreover in no event can interest accrue in bankruptcy after the completion of the sale of the mortgaged property with the consent of the mortgagee. In accordance with the general rule applicable to receivership, assignment for the benefit of creditors, and judicial sale proceedings, the bankruptcy rule is clear that when the court with the mortgagee's consent orders a sale free of liens, the latter to attach to the proceeds of the sale, even as against general creditors, interest does not run beyond the day the purchaser at the sale has paid the purchase price in full, even though the proceeds are sufficient to meet further claims.

ARGUMENT.

I.

The Tax Liens of the United States Were Entitled to Priority in Payment Over the Tax Liens of the State of California.

The question on this phase of the appeal is whether the claim of the United States can be subordinated to any sum greater than the amount properly allowable to the Universal Consolidated Oil Company on its mortgage. Specifically the issue deals with the relative priorities of the State of California and the United States as *lien* claimants. The Government's liens [Sections 3670-3672, Internal Revenue Code, Appendix, *infra*] for gasoline taxes due under Section 3412 (a) of the Internal Revenue Code [Appendix, *infra*] attached in sufficient sums for purposes of this appeal prior to the filing of the petition on May 12, 1942. [R. 70.][3] It is the Government's position that at the time the Government's liens attached the State of California had at most inchoate unperfected liens for franchise taxes under Sections 25 and 29 of the California Franchise Tax Act [Appendix, *infra*] and that in a contest in bankruptcy between a prior inchoate lienholder and the Government as a tax *lien claimant,* the Government takes priority regardless of whether the inchoate lien is subsequently perfected.

In general, lien claimants fall under Section 67 of the National Bankruptcy Act of 1898, as amended by the Chandler Act of 1938 [Appendix, *infra*], and must be

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[3]Where bankruptcy follows a petition for reorganization under Chapter X, the crucial date is still the filing of the original petition under Chapter X, Section 238 of the Bankruptcy Act; *In re Columbia Ribbon Co.,* 117 F. (2d) 999 (C. C. A. 3d).

paid in advance of unsecured claims arising under Section 64. [Appendix *infra.*] *City of Richmond v. Bird,* 249 U. S. 174; *In re Brannon,* 62 F. (2d) 959 (C. C. A. 5th). Unsecured claims for taxes are afforded a fourth priority under Section 64 and claimants share pro rata. *Missouri v. Ross,* 299 U. S. 72. But a lien creditor under Section 67 is ahead of tax claimants without liens under Section 64 (*City of Richmond v. Bird, supra; Miners Sav. Bank of Pittston, Pa. v. Joyce,* 97 F. (2d) 973, 974 (C. C. A. 3d)), and the tax lien under Section 67 takes precedence over the priorities under Section 64, with the possible subordination exceptions of Section 67 (c) ((*Ingram v. Coss County, Or.,* 71 F. (2d) 889 (C. C. A. 9th); *In re Empire Granite Co.,* 42 F. Supp. 450)). An inchoate lien for taxes is still a statutory lien protected by Section 67 (b) and is ahead of any claim for taxes without a lien under Section 64. *In re Knox-Powell-Stockton Co.,* 100 F. (2d) 979 (C. C. A. 9th). And this is so even if the unsecured tax claimant is the United States, for Section 3466, Revised Statutes, does not apply. *In re Knox-Powell-Stockton Co., supra; United States Fidelity & Guaranty Co. v. Sweeney,* 80 F. (2d) 235 (C. C. A. 8th); *Reese, Inc. v. United States,* 75 F. (2d) 9 (C. C. A. 5th). But this merely means that the Bankruptcy Act sets up its own priorities, and since any lien under Section 67, even unperfected, is preferred to an unsecured claim, though a priority, under Section 64, the United States cannot insist upon the priority of Section 3466, Revised Statutes, which does not create a lien. *Bramwell v. U. S. Fidelity Co.,* 269 U. S. 483, 488.

The nature of the Government's lien for taxes has been judicially settled. After demand it arises at the time the

assessment list was received by the Collector. (Sections 3670-3671, Internal Revenue Code; *In re Lambertville Rubber Co.,* 111 F. (2d) 45 (C. C. A. 3d); *Metropolitan Life Ins. Co. v. United States,* 107 F. (2d) 311 (C. C. A. 6th); *In re Fahnestock Mfg. Co.,* 7 F. (2d) 777 (W. D. Pa.); *Citizens State Bank of Barstow, Tex. v. Vidal,* 114 F. (2d) 380 (C. C. A. 10th); *cf. MacKenzie v. United States,* 109 F. (2d) 540 (C. C. A. 9th)). It is a specific perfected lien (*United States v. City of Greenville,* 118 F. (2d) 963 (C. C. A. 4th)) which cannot be displaced by later liens imposed by the authority of any state law or judicial decision (*Michigan v. United States,* 317 U. S. 338). Except for failure to record as to specific enumerated classes, it is good against a subsequent state lien regardless of state priorities, takes precedence over a prior inchoate state tax lien (*United States v. Reese,* 131 F. (2d) 466 (C. C. A. 7th)), and may possibly have priority over a previously perfected lien (*Michigan v. United States, supra*), though possibly not over a mortgage (*Metropolitan Life Ins. Co. v. United States, supra; Ormsbee v. United States,* 22 F. (2d) 926 (S. D. Fla.)).

Questions concerning inchoate general liens have generally arisen with regard to the application of Section 3466, Revised Statutes (*United States v. Waddill, Holland & Flinn* (U. S. Sup. Ct.), decided January 2, 1945 (1945 P-H, par. 72,008); *United States v. Texas,* 314 U. S. 480; *New York v. Maclay,* 288 U. S. 290; *Spokane County v. United States,* 279 U. S. 80); and Section 67 (b) of the Bankruptcy Act (*In re Knox-Powell-Stockton Co., supra* (old Section 67 (d)); *City of New Orleans v. Harrell,* 134 F. (2d) 399 (C. C. A. 5th); *City of New York v. Hall,* 139 F. (2d) 935 (C. C. A. 2d)). In general they

may be defined as caveats of more perfect liens to come, either because the amount of, or the property subject to, the lien is not fixed or certain.

It is submitted that the proper application of the above principles to the facts at bar irrefutably leads to the conclusion that the Government's *liens* for gasoline taxes were entitled to be satisfied before the franchise tax liens of the State of California. There can be little argument over the fact that the California liens were inchoate and general at the time of the filing of the petition on May 12, 1942. Section 4 (3) of the California Franchise Tax Act provides that the tax is to be measured by the corporation's net income computed upon the basis of its preceding fiscal or calendar year; that is, the 1939 and 1940 corporate franchise taxes here involved were measured by the net income of the El Camino Refining Company for the years 1938 and 1939. Section 7 provides that the franchise tax shall accrue on the first day of the "taxable year," the year when the tax is payable. (Section 11 (b).) Corporations are required to file a return within two months and fifteen days after the close of their income year (Section 13) and to pay the tax reported on the return (Section 23). However, Section 25 [Appendix, *infra*], provides that if the franchise tax commissioner determines that the tax disclosed by the original return is less than the tax disclosed by his examination, he shall mail notice of the additional tax *proposed to be assessed*, and that within sixty days the taxpayer may file a protest against the levy of the *proposed additional tax* as computed by the commissioner. If no protest is filed, the amount of the tax is final upon the expiration of a sixty day period. But if the taxpayer files a protest within

sixty days, it is then the duty of the commissioner to reconsider his computation of the tax complained of, and the commissioner's action upon the protest becomes final upon the expiration of thirty days from the date when he mails the taxpayer a notice of his action. After the deficiency is determined and the tax becomes final, the commissioner must mail notice of demand for the payment thereof and the tax is due and payable ten days later. It is further provided that upon the adjudication of bankruptcy of any taxpayer, any deficiency determined by the franchise tax commissioner in respect to the tax imposed by the Act *may be immediately assessed.* Section 29 [Appendix, *infra*] creates the lien that secures payment of the taxes. The taxes constitute a lien upon the real property of the taxpayer, which lien has the same force, effect and priority as a judgment lien, and attaches on the first day of the taxable year.

The El Camino Refining Company filed its California franchise tax returns for the taxable years 1939 and 1940, reporting its computation of income received during the income years of 1938 and 1939, and paid the taxes shown to be due for the taxable years 1939 and 1940 by the returns. [R. 81-82.] Thereafter, on January 3, 1941, the California franchise tax commissioner, under the provisions of Section 25 of the Act, determined that additional income had been received and additional amounts of taxes were due, and gave notice to the bankrupt that the returns filed by the bankrupt had been examined, the correct amount of taxes determined by the commissioner, and that he *proposed to assess additional taxes.* [Trustee's Ex. No. 1, R. 91-94.] At this moment no tax was final under Section 25. Moreover, the bankrupt filed a protest with

the California franchise tax commissioner [R. 82], and on May 12, 1942, the protest was still pending. It was not until August 13, 1942,[4] that the tax liability was finally redetermined. No assessment was made prior to the petition in bankruptcy and no tax was due and payable until ten days from the time the notice and demand was sent out on August 13, 1942. [Trustee's Ex. No. 2, R. 95-98.] Thus, although the liens attached pursuant to Section 29 as of the first day of 1939 and 1940, the amount of their liability was unliquidated and unknown. This did not deprive them of being valid liens within Section 67 (b) of the Bankruptcy Act (*In re Knox-Powell-Stockton & Co., supra; United States v. Reese,* 131 F. (2d) 466 (C. C. A. 7th)): but it did deprive them of being specific and perfect. Moreover, by Section 29 of the California Franchise Tax Act, the liens have the same force, effect and priority as judgment liens. Even had their amount been liquidated prior to bankruptcy, they still would have been merely the general lien of a judgment which requires seizure or the equivalent to remove it from the category of an inchoate or floating lien. *Thelusson v. Smith,* 2 Wheat. 396, 426; *New York v. Maclay, supra; In re Lincoln Chair & Novelty Co.*, 274 N. Y. 353. Hence, under any analysis, the State of California had but inchoate general liens uncertain as to amount and property subject thereto.

On the other hand, the liens of the United States were specific and perfect (*United States v. City of Greenville, supra; Michigan v. United States, supra*), arising at the

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[4]The State of California did not file its claim in the bankruptcy proceeding for these taxes until April 3, 1943. [R. 65.] The United States filed its claim on June 20, 1942. [R. 70.]

times the assessment lists were received by the Collector,[5] which in a sufficient number of instances were prior to the filing of the petition. [R. 70.] And the liens were valid as against the State of California even though they were not recorded pursuant to Section 3672 of the Internal Revenue Code [R. 35], since a state is not among the classes enumerated in and protected by the statute.[6] *United States v. San Juan County,* 280 Fed. 120 (W. D. Wash.); *Hopkins v. Eureka Coal Co.* (C. C. Kanawha Co., W. Va.), decided February 25, 1944 (1944 P-H, par. 92,496); *State v. Wynne,* 113 S. W. (2d) 325 (Tex. Civ. App.), reversed on other grounds, 133 S. W. (2d) 951 (Tex. Sup. Ct.); see also *Investment & Securities Co. v. United States,* 140 F. (2d) 894 (C. C. A. 9th); *In re Dartmont Coal Co.,* 46 F. (2d) 455 (C. C. A. 4th).

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[5]Demand for payment required by Section 3670 of the Internal Revenue Code, which need not be a formal demand (*In re Baltimore Pearl Hominy Co.,* 5 F. (2d) 553 (C. C. A. 4th), is evidenced by the admission in the original petition [R. 4], or, since Section 67 (b) of the Bankruptcy Act now expressly allows statutory liens to be perfected after bankruptcy, by the claim filed on June 20, 1942. [R. 70.] Under old Section 67 (d) several courts had held that statutory liens could not be perfected after bankruptcy. See *City of New Orleans v. Harrell,* 134 F. (2d) 399 (C. C. A. 5th).

[6]Although there is no contest with the trustee in bankruptcy, who represents the United States as well as other creditors, the liens obviously were good against him without recording. The trustee in bankruptcy likewise is not specifically listed in the enumerated classes of those to whom Congress has consented to be subordinated, and under Section 70 (c) of the Bankruptcy Act, he is not actually a judgment creditor as to property in the possession of the bankrupt. He is merely a creditor holding a lien by legal or equitable proceedings, and the Bankruptcy Act clearly recognizes the difference between the two types of creditors, for in the same section the trustee is constituted a judgment creditor as to all other property not in the bankrupt's possession or otherwise coming into the possession of the bankruptcy court.

The question is thus narrowed down to the priority between the specific tax liens of the United States and the inchoate general judgment liens of the State of California. The *In re Knox-Powell-Stockton Co.* case, *supra,* gives no answer, for it merely held that a state inchoate tax lien good under Section 67 (b) was superior to a United States *unsecured* tax priority claim under Section 64. But *United States v. Reese,* 131 F. (2d) 466 (C. C. A. 7th), *supra;* and *Michigan v. United States, supra.* do supply the answer. In the *Reese* case, which involved a dispute between two *lien* claimants in *bankruptcy,* the inchoate tax liens of the state attached in April of 1930 and 1931 while the Government's specific tax lien did not arise until December, 1931. The taxes due the State of Illinois were uncertain in amount at all times prior to the date of inception of the Government's lien though they were made certain thereafter. The court by analogy to Section 3466, Revised Statutes, held that the United States was prior in time and therefore superior in dignity, which priority could not be defeated by any doctrine of relation back. 4 Collier on Bankruptcy (1944 Supp.) in stating as part of his treatise that (p. 14)—

> If the United States had a *lien* for taxes pursuant to federal law then it should be valid in bankruptcy under §67b and should take precedence over the state tax lien if the federal statutes give it precedence, * * *

comments on the *Reese* case as follows (p. 13):

> In *United States v. Reese* (C. C. A. 7th, 1942), 51 Am. B. R. (N. S.) 660, 131 F. (2d) 466, the court held that a tax *lien* of the United States was entitled to precedence over an Illinois real property tax lien by virtue of 36 U. S. C., §191. To give this section

> such effect in determining the ranking of *liens* is, of course, consistent with the holding that the section does not in bankruptcy give the government *without a lien* precedence over a lien, or in other words §191 gives only a fifth priority to an *unsecured* claim of the United States.

And in the *Michigan* case, *supra*, also a tax lien case, the Supreme Court also drew upon the analogy to the priority of payment demanded by Section 3466, Revised Statutes, and left open the question of the supremacy of the federal lien over a *previously perfected state lien*, thus lending support to the view that a previously inchoate general state lien must fall before the federal tax lien.

Moreover, *United States v. Texas,* 314 U. S. 480, conclusively answers any argument which the State of California may advance that since the mortgage was conceded to prime the Government's tax liens and the state liens for franchise taxes were entitled to be satisfied under California law before the mortgage, the state liens were entitled to first priority. In the *Texas* case a receiver was appointed for a gasoline distributor at the suit of a chattel mortgagee. Texas and the United States then intervened with claims for state and federal gasoline taxes. The District Court held that the mortgagee was to be first satisfied, then the United States under Section 3466, Revised Statutes, and finally the claims of Texas. But pursuant to a ruling of the Texas Supreme Court which held (133 S. W. (2d) 963) that the Texas statute gave its lien first rank over prior mortgagees and the United States claim, the order of distribution was entered to be: Texas, the mortgagee, then the United States. Certiorari was granted on the petition of

the United States which did not seek to disturb the superior rights of the mortgagee. The only question before the United States Supreme Court was the relative priority of the claims of the United States and Texas. The Court held the United States was entitled to priority over Texas. And it did so in light of the binding construction of the Texas Supreme Court of its local statute that the state lien was to be preferred over the mortgage and whether or not the mortgage was entitled to priority over the United States. Thus the State of California cannot successfully claim to be entitled to payment before the United States because it asserts a state priority over the mortgagee.

It should be noted that the Government in the case at bar does not assert that because it primes the state liens which in turn are superior to the mortgage, it should be paid first. This was the solution of the Court of Civil Appeals of Texas when the *Texas* case, *supra*, was sent back to it on remand, for it said (*State v. Nix*, 159 S. W. (2d) 214):

> It has thus been determined by the State Supreme Court that Dailey's * * * claim is inferior to that of the State of Texas, and the U. S. Supreme Court has held that the State's claim is inferior to that of the Federal Government. The funds in the treasury of the trial court are insufficient to satisfy the judgment in favor of the Federal Government and no necessity arises for apportioning any deficit after payment of the judgment due the Federal Government. * * *.
>
> * * * That part of the judgment giving priority to the State of Texas over the judgment in favor of the Federal Government will be reformed and prior-

> ity will be given to the latter over the former. * * *.
>
> In this appeal, both Howard Dailey and the State have lost as against the Federal Government; the State has prevailed over Dailey.

The Government, however, urges that the procedure inferentially approved in *Spokane County v. United States,*[7] 279 U. S. 80, and specifically followed in *Hopkins v. Eureka Coal Co., supra,* be adopted here. In the *Eureka Coal Company* case, which involved *tax liens,* the Government recognized the priority of the mortgagee's lien which was inferior to the state consumer's sales tax liens, yet successfully claimed precedence over the state liens. The court directed that the mortgagee's lien be satisfied first, United States next, and the State third, with a provision for setting aside any amounts which should go to the mortgagee to satisfy the state taxes. So here the amount finally to be allowed to the Universal Consolidated Oil Company should be paid first and the tax liens of the United States thereafter, with a provision that the State of California satisfy its tax claims out of the amounts allowable to the mortgagee.[8]

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[7]Moreover, it is contended by the Government that the relative priorities could have been maintained . . . by setting apart sufficient funds to pay the mortgage before paying the federal taxes and then providing for payment of the state tax out of the sum so set apart.

[8]Aside from the question of the supremacy of the federal tax lien, the courts have been struggling over the "circuity of liens" and "priorities puzzle" for more than two and a half centuries. See Note, 38 Col. L. Rev. 1267 (1938). In cases such as the one at bar where California has a lien superior to that of the mortgagee, the mortgagee has a lien superior to that of the United States, and the United States has a lien superior to that of California, normal common law rules would subordinate California to both the mortgagee and the United States. See Glenn, Mortgages, Sec.

II.

It Was Error to Allow Interest to the Mortgagee Subsequent to the Date of Adjudication in Bankruptcy or Sale of the Mortgaged Property, With Its Consent, and to Subordinate the Tax Liens of the United States to Such Payments.

The District Court awarded to the mortgagee, the Universal Consolidated Oil Company, the principal sum due on its mortgage as of the date of the petition in May, 1942—some $8,000—plus interest until the date of payment.[9] By consent of all the lien claimants including the mortgagee, the security had been sold free and clear of all liens, which were transferred to the funds realized from the completed sales. See *Van Huffel v. Harkelrode*, 284 U. S. 225. It is submitted, therefore, that not only was it error to subordinate the Government's specific tax liens to the payment of any interest from the moment the liens attached, but under the ordinary rules applicable to bankruptcy, no interest was properly allowable after the filing of the petition or surely after the consummated sales of the mortgaged property.

375, and cases there collected; Benson, Circuity of Liens—Problem in Priorities, 19 Minn. L. Rev. 139 (1935). The Fifth Circuit's treatment of the problem where city taxes were involved (*City of New Orleans v. Harrell*, 134 F. (2d) 399 (C. C. A. 5th)) is criticized in 4 Collier on Bankruptcy (1944 Supp.) 13. However, the criticism is not applicable to the instant case, since the supremacy of the federal tax lien was not there involved, and unlike the *New Orleans* case, all the contestants here claim liens on real estate which by consent and not the automatic provision of Section 67 (b) have all been subordinated to the same expenses of administration. [R. 62.]

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[9]The addition of the $750 attorney's fees to the principal sum will be discussed subsequently.

We of course recognize that the general rule that interest stops running upon both secured (*Brown v. Leo,* 34 F. (2d) 127 (C. C. A. 2d)) and unsecured claims after a debtor has passed into bankruptcy unless the estate turns out to be solvent (*Sexton v. Dreyfus,* 219 U. S. 339; *Am. Iron Co. v. Seaboard Air Line,* 233 U. S. 261), is limited by the exception in favor of the secured creditor whose security is sufficient to pay his claim for interest as well as principal. (*Coder v. Arts,* 213 U. S. 223; *People's Homestead Ass'n v. Bartlette,* 33 F. (2d) 561 (C. C. A. 5th); *In re Gotham Can Co.,* 48 F. (2d) 540 (C. C. A. 2d); see *Ticonic Bank v. Sprague,* 303 U. S. 406; *Louisville Bank v. Bradford,* 295 U. S. 555, 557.) However, the exception is itself circumscribed where the contest is not between secured and general creditors but between two lienholders on the same property, as is the case here. Just as priority claims not secured by liens are not granted interest unless principal of all claims may be paid in full (*Fordyce v. Kansas City & N. Connecting R. Co.,* 145 Fed. 566 (C. C. W. D. Mo.)), so where property is subject to two liens, interest will not run on the superior to the detriment of the principal of the second. (*Lerner Stores Corp. v. Electric Maid Bake Shops,* 24 F. (2d) 780 (C. C. A. 5th); but see *Wilson v. Dewey,* 133 F. (2d) 962 (C. C. A. 8th.). In *People's Homestead Ass'n v. Bartlette, supra,* where interest was allowed the mortgagee after bankruptcy on the proceeds realized from the sale of the security until the time the vendee paid the purchase price, the court expressly distinguished the situation in the *Lerner* case, *supra,* as one involving a contest between two secured creditors and not similar to that involved in the case it was then deciding where the issue arose between general claimants and a mortgagee. Thus,

in the case at bar, the court was in error to allow interest to the mortgagee from the day of the petition to the detriment of the principal sum due the United States as the second lienor.

But there is a more fundamental reason why, aside from any question of insolvency, the mortgagee is not entitled to subordinate the United States tax liens to a greater sum than existed on the date the Government's liens attached.[10] At that moment since there was no equity in the property for the bankrupt, the property had in a sense two owners, the mortgagee to the extent of its debt, and the United States to the extent of its liens. See *United States v. City of Greenville,* 118 F .(2d) 963 (C. C. A. 4th). Although Congress may have subordinated its tax lien to a prior existing mortgage, the lien cannot be displaced without its consent by increasing the amount of the prior incumbrance by the accrual of interest pursuant to state law or judicial decision. See *Michigan v. United States*, 317 U. S. 338. As the Supreme Court in the *Michigan* case, *supra,* which also involved a tax lien, drew upon the analogy of decisions interpreting the priority of payment demanded by Section 3466, Revised Statutes, so here the interest cannot be said to be an incident of and relate back to the original debt, for the doctrine of relation will not divest the United States of its priority. *New York v. Maclay,* 288 U. S. 290. Since the mortgage was filed prior to the inception of the Government's lien, it is beyond argument that the notice provisions of Section 3672 of the Internal Revenue Code, which are to protect subsequent mortgagees, have no application to the case at bar. See *In re Van Winkle,*

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[10]In accordance with the fourth assignment of error, interest accruing up to the date of adjudication is not attached.

49 F. Supp. 711, 713 (W. D. Ky.); *Cf. United States v. Beaver Run Coal Co.,* 99 F. (2d) 610 (C. C. A. 3d); *Ormsbee v. United States,* 23 F. (2d) 926 (S. D. Fla.). Accrual of interest on the mortgage debt is not within the classes enumerated in and protected by the statute. See *MacKenzie v. United States,* 109 F. (2d) 540 (C. C. A. 9th).

But in no event can interest accrue in bankruptcy after the completion of the sale of the mortgaged property with the consent of the mortgagee. Obviously, if the sale results in a deficiency, the mortgagee is a common creditor, *ad hoc;* and when he seeks to prove against the general estate for the deficiency claim as a debt, interest stops at the point where it halts as to other general debts, the day of the filing of the petition. *Sexton v. Dreyfus, supra.* However, when the court with the mortgagee's consent[11] orders a sale free of liens, the latter to attach to the proceeds of the sale, even as against general creditors, interest does not run beyond the day the purchaser at the sale has paid the purchase price in full, even though the proceeds are sufficient to meet further claims. *Coder v. Arts,* 213 U. S. 223, *supra,* affirming 152 Fed. 943 (C. C. A. 8th). Thus, in *In re Stevens,* 173 Fed. 842 (Ore.), where the mortgaged property was sold free of liens and the referee allowed

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[11]That the consent of the lienholder to a sale free of liens may subject him to liability for a part of the general administration expenses which he otherwise would not have to share, see *Tawney v. Clemson,* 81 F. (2d) 301 (C. C. A. 4th).

interest to date of adjudication only, the court held that interest ceased only when the trustee received the proceeds of the sale of the property, and that the bankrupt estate ought not to be burdened with the payment of interest subsequent to that time. And in *People's Homestead Ass'n v. Bartlette, supra,* where the referee awarded interest to date of sale, the appellate court allowed it to run until the time the purchaser paid the purchase price. [12]Compare *Phoenix Bldg. & Homestead Ass'n v. E. A. Carrere's Sons,* 33 Fed. (2d) 563 (C. C. A. 5th), (interest not contested on appeal); *In re Hershberger,* 208 Fed. 94 (M. D. Pa.); *San Antonio Loan & Trust Co. v. Booth,* 2 Fed. (2d) 590 (C. C. A. 5th). Thus, even if the United States were treated purely as an unsecured creditor the District Court was in error to award interest on the principal of the mortgage up to the date of payment to the mortgagee.

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[12]This is in accordance with the general rule applicable to insolvency and judicial sale proceedings. Thus, in *Roos v. Fairy Silk Mills,* 342 Pa. 81, a receivership case where land subject to two mortgages was sold by order of court, it was held that interest ceased on the first mortgage at the date of payment of the purchase price despite litigation between the first and second mortgagees, instituted by the second, as to their respective rights to the proceeds of the sale, and against the contention of the first mortgagee that interest should run to date of distribution. To the same effect is *Meister v. J. Meister, Inc.,* 103 N. J. Eq. 78. The date of final confirmation by the court of the sale of the assignor's real estate by his assignee for benefit of creditors under order of court is the time for interest on liens to cease (*Carver's Appeal,* 89 Pa. 276), and interest in such a case does not run to date of distribution of the proceeds of the sale (*Estate of John Strickler,* 13 Phila. 504). And interest ceases to run on liens discharged by a sheriff's execution sale of real property on the date of the sale and not the date of distribution. *Potter v. Langstruth,* 151 Pa. 216.

III.

The Tax Liens of the United States Were Entitled to Be Satisfied Ahead of the Attorney's Fees Awarded to the Mortgagee.

The mortgage provided that it was to secure payment of attorney's fees for services rendered in any (R. 66)—

> action brought to foreclose this mortgage, or in any action or proceeding affecting or purporting to affect the security of this mortgage or the rights of the mortgagee hereunder * * *.

The attorneys for the mortgagee had participated in the sale of the mortgaged property and represented the mortgagee in successfully upholding against the contention of the United States its claim to a lien on the oil refinery property. For these services $750 was awarded by the referee and made a part of the lien of the mortgage. Although applicable California law designating attorney's fees secured by the mortgage as part of the principal lien (*County Bank v. Goldstree,* 129 Cal. 161) will be recognized as a component part of the valid lien in bankruptcy (*Security Mortgage Co. v. Powers,* 278 U. S. 149), it is the Government's contention that once the Government's lien attached, it was subordinated only to the amount then due on the mortgage. As was argued in the discussion of the interest issue in Part II, *supra,* this sum could not be opened up and increased by attorney's fees for services to be performed in the future by any doctrine of relation back.

Conclusion.

The judgment of the District Court is incorrect and should be reversed.

Respectfully submitted,

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March, 1945.

APPENDIX.

Internal Revenue Code, [as amended by Sec. 521 (a) (20) of the Revenue Act of 1941, c. 412, 55 Stat. 687]:

SEC. 3412. TAX ON GASOLINE.

(a) There shall be imposed on gasoline sold by the producer or importer thereof, or by any producer of gasoline, a tax of 1½ cents a gallon, except that under regulations prescribed by the Commissioner with the approval of the Secretary the tax shall not apply in the case of sales to a producer of gasoline.

* * * * * * * * *

(26 U. S. C. 1940 ed., Sec. 3412.)

SEC. 3670. PROPERTY SUBJECT TO LIEN.

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

(26 U. S. C. 1940 ed., Sec. 3670.)

SEC. 3671. PERIOD OF LIEN.

Unless another date is specifically fixed by law, the lien shall arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time.

(26 U. S. C. 1940 ed., Sec. 3671.)

SEC. 3672. [as amended by Sec. 401 of the Revenue Act of 1939, c. 247, 53 Stat. 862]. VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITORS.

(a) *Invalidity of Lien Without Notice.*—Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector—

* * * * * * * * *

(26 U. S. C. 1940 ed., Sec. 3672.)

Deering, California General Laws (1939 Supp.):

Act 8488. Bank and Corporation Franchise Tax Act:

SEC. 25. *Examination of returns and proceedings thereafter: Notice of additional tax.* As soon as practicable after the return is filed, the commissioner shall examine it and shall determine the correct amount of the tax. If the commissioner determines that the tax disclosed by the original return is less than the tax disclosed by his examination he shall mail notice to the taxpayer at its post-office address (which must appear on its return) of the additional tax proposed to be assessed against it. Such notice shall set forth the details of the proposed additional assessment and of computing said tax.

Protest by taxpayer. Within sixty days after the mailing of said notice the taxpayer may file with the commissioner a written protest against the levy of the proposed additional tax, as computed by the commissioner, specifying therein the grounds upon which the protest is based. The protest must be under oath.

Hearing and appeal. If no such protest is so filed the amount of the tax shall be final upon the expiration of said sixty-day period. If a protest is so filed it shall be the duty of the commissioner to reconsider the computation and levy of the tax complained of, and if the taxpayer has so requested in its protest, it shall be the duty of the commissioner to grant said taxpayer, or its authorized representatives, an oral hearing. After consideration of the protest and the evidence adduced in the event of such oral hearing, the commissioner's action upon the protest shall be final upon the expiration of thirty days from the date when he mails to the taxpayer notice of his action, unless within that thirty-day period the taxpayer appeals in writing from the action of the commissioner to the State Board of Equalization. The appeal must be addressed and mailed to the State Board of Equalization at Sacramento, and a copy of the appeal addressed and mailed at the same time to the commissioner at Sacramento. Said board shall hear and determine the same and thereafter shall forthwith notify the taxpayer and the commissioner of its determination, and the reasons therefor. Such determination shall be final upon the expiration of sixty days from the time of such determination unless within such sixty-day period the determination is modified in which event it shall become final upon the expiration of sixty days from the time it is modified.

Deficiency notice. When a deficiency has been determined and the tax has become final under the provisions of this section, the commissioner shall mail notice and demand to the taxpayer for the payment thereof, and such tax shall be due and payable at the expiration of ten days from the date of such notice and demand.

* * * * * * * * *

Bankruptcy of taxpayer. Upon the adjudication of bankruptcy of any taxpayer in any bankruptcy proceeding or the appointment of a receiver for any taxpayer in any receivership proceeding before any court of the United States or of any State or Territory or of the District of Columbia, any deficiency (together with all interest, additional amounts, or additions to the tax provided for by law) determined by the commissioner in respect of a tax imposed by this act upon such taxpayer may be immediately assessed. * * *

SEC. 29. *Lien of tax: Inception and duration: Release of lien: Prerequisites to dissolution of taxpayer.* (a) The taxes imposed by this act shall constitute a lien upon the real property of the taxpayer, which lien shall have the same force, effect and priority as a judgment lien and shall attach on the first day of the "taxable year," * * *.

* * * * * * * * *

Bankruptcy Act of 1898, c. 541 30 Stat. 544, as amended by the Act of June 22, 1938, c. 575, 52 Stat. 840:

SEC. 64. *Debts Which Have Priority.* a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be * * * (4) taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof: * * *

* * * * * * * * *

(11 U. S. C. 1940 ed., Sec. 104.)

SEC. 67. *Liens and Fraudulent Transfers.*

* * * * * * * * *

b. The provisions of section 60 of this Act to the contrary notwithstanding, statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or any State or subdivision thereof, created or recognized by the laws of the United States or of any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition in bankruptcy or of the original petition under chapter X, XI, XII, or XIII of this Act, by or against him. Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, if perfected within the time permitted by and in accordance with the requirements of such laws, except that if such laws require the liens to be perfected by the seizure of property, they shall instead be perfected by filing notice thereof with the court.

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(11 U. S. C. 1940 ed., Sec. 107.)